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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-341

DONALD L. MAINS and JOYCE G. MAINS, *Petitioners*

vs.

UNITED STATES OF AMERICA, *Respondent.*

F. E. GOODING, *Petitioner*

vs.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit

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PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
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The Petitioners, F. E. Gooding, deceased, Donald L. Mains and Joyce G. Mains, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on January 13, 1975 and April 14, 1978.

OPINIONS BELOW

The first opinion of the District Court is reported at 372 F. Supp. 1093. The first opinion of the Court of Appeals is reported at 508 F. 2nd 1251.

The second decision of the District Court upon remand is not officially reported but is unofficially reported at 76-2 USTC ¶9520.

The second opinion of the Court of Appeals is not at this time officially reported but is unofficially reported at 78-1 USTC ¶9414. (See Appendix)

JURISDICTION

The judgments of the Court of Appeals were entered January 13, 1975, and April 14, 1978. The judgment denying rehearing by the Court of Appeals was entered on May 31, 1978. (See Appendix) The jurisdiction of this Court is invoked under 28 U.S.C.A. Sec. 1254(1).

QUESTIONS PRESENTED

Pursuant to plans of complete liquidation under Section 337 of the Internal Revenue Code of 1954 two Ohio corporations in 1966 sold certain business assets, tangible and intangible, and distributed the proceeds on a pro rata basis to the shareholders, which included Petitioners. In a subsequent taxable year the corporations abandoned their plans of complete liquidation under Section 337.

I

Whether the subsequent abandonment of the Section 337 plans of complete liquidation precludes the 1966 distribution from treatment as in partial liquidation under Section 346(a)(1) of the Internal Revenue Code of 1954, and

II

Whether the Courts below applied proper legal standards in determining that the 1966 distributions to the shareholders

from the proceeds of the liquidating sale did not constitute a sufficient "corporate contraction" for such disposition and distribution to constitute a partial liquidation under Section 346(a)(2) of the Internal Revenue Code of 1954, and

III

Whether the Courts below applied the proper legal standards in determining that the assets disposed of pursuant to the plans of complete liquidation under Section 337 of the Internal Revenue Code of 1954 did not constitute a "trade or business" as that term is defined for the purposes of Section 346(b) of the Internal Revenue Code of 1954?

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Internal Revenue Code of 1954

Sec. 331. Gain or Loss to Shareholders in Corporate liquidations.

(a) General Rule. —

(1) Complete Liquidations. — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

(2) Partial Liquidations. — Amounts distributed in partial liquidation of a corporation (as defined in Section 346) shall be treated as in part or full payment in exchange for the stock.

(b) Nonapplication of Section 301. — Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property (other than a distribution referred to in paragraph (2) (B) of Section 316 (b)), in partial or complete liquidation.

Sec. 346. Partial Liquidation Defined.

(a) In General. — For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if —

(1) the distribution is one of a series of distributions in

redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562 (b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) Termination of a Business. — A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(c) Treatment of Certain Redemptions. — The fact that, with respect to a shareholder, a distribution qualifies under

section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock) by reason of section 302 (b) shall not be taken into account in determining whether the distribution, with respect to such shareholder, is also a distribution in partial liquidation of the corporation.

Regulations of The Commissioner of Internal Revenue

Reg. § 1.346-1(c)

*** The term "active conduct of a trade or business" shall have the same meaning in this section as in paragraph (c) of § 1.355-1.

Reg. § 1.355-1(c)

*** a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. ***

STATEMENT

Gooding Amusement Company and Thrills, Inc., were two Ohio corporation engaged in the road carnival business for over thirty years and whose taxable years ended on August 30 and June 30, respectively. Petitioners were shareholders in the two corporations. Petitioner F. E. Gooding (deceased) owned over 50% of the stock in both corporations. Petitioner, Joyce Mains, deceased's daughter, was a minority shareholder along with other employees of the two corporations.

On April 5, 1966, the two corporations entered into plans of complete liquidation under Section 337 of the Internal Revenue Code of 1954, a twelve month liquidation plan providing for no recognition of capital gain at the corporate level if such plans could be consummated within the twelve month period. Required information returns, Form 966, were filed with the

Internal Revenue Service. On April 6, 1966, pursuant to said plans, the corporations sold Gooding's Million Dollar Midway (also referred to as the Southern Route). The sales price was $375,000.00 and the purchase in addition to the equipment included certain contract rights, good will and covenants not to compete. The manager and personnel who operated this carnival unit went with and were employed by the purchasing group, the manager being a part of this group. The net proceeds from the sale of this business were distributed pro rata to the shareholders of the corporation and stock redemptions made accordingly. This segment of the corporations had actively conducted a trade or business throughout the five-year period ending on the date of the distributions.

Gooding's Million Dollar Midway accounted for over a third of the gross income of Gooding Amusement and substantially all of its profits. The net book value of the physical assets sold was $102,281.55.

Gooding's Million Dollar Midway operated as a completely separate business in the carnival operation of the corporations, with the exception that in off season it stored its equipment on common premises (segregated) and the general office of the corporations participated in the negotiations of some performance contracts, advanced some deposits to guarantee contract performances and arranged for a minimal amount of poster advertising. This unit kept its own books and records, collected its income, paid its own expenses, operated in an established geographical area, had its own separate management and personnel, and advertised under its separate trade name.

The purchasing group had a one year option to purchase the balance of the assets of the corporations, but in January, 1967, declined to exercise this option as being a poor investment.

Being unable to find a feasible alternative for complete liquidation under Section 337 of the Internal Revenue Code of 1954, within the twelve month period, the corporations abandoned these plans.

The corporations as required by law notified the Internal Revenue Service on April 1, 1967, of the abandonment of the plans of complete liquidation under Section 337 and of their intention to proceed under the partial liquidating provisions of Section 346 (Form 966).

The balance of the operating assets, less real estate, were sold by the corporations for $540,000.00 on May 15, 1975, in their continuing plans to completely liquidate.

REASONS FOR GRANTING THE WRIT

I

The Sixth Circuit's and District Court's interpretation and analysis of Section 346(a)(1) of the Internal Revenue Code of 1954 is in direct conflict with that of the Seventh Circuit, the opinions of this Honorable Court regarding the essential integrity of each tax year (barring some fraud or palpable tax avoidance scheme) and, by clear inference, with the decisions of various other courts.

The corporations involved entered into formal plans of complete liquidation in April, 1966 and pursuant thereto sold an operating portion of the business and distributed the proceeds pro rata to the shareholders, which included petitioners. The Courts below in their various opinions (see appendix) recognize that these plans of complete liquidation were abandoned in the subsequent taxable year of 1967. Yet their opinions, based on Petitioners failure to meet the burden of showing that the sale of corporate assets was "part of a settled and informal plan to liquidate" the corporations in some subsequent taxable year, does not designate what taxable year or period of time is being referred to. This despite the fact that the existence of genuine plans of complete liquidation throughout the 1966 taxable year is not questioned.

This Court set the perimeters in honoring the integrity of each tax year in *Burnet v. Sanford & Brooks Co.* 282 U.S. 359 (1931) as follows:

"It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practical to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. . . . While, conceivably a different system (other than an annual accounting period) might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained result of particular transactions, Congress is not required by the amendment (the sixteenth amendment to the Constitution) to adopt such a system in preference to the more familiar method, (annual accounting period), even if it were practicable."

This position was affirmed in *Heiner v. Mellon* 340 U.S. 271 (1938) in the following language:

"Nor is it of legal significance that the liquidation was not completed until 1925 and that until completion of the liquidation it could not be known whether the business venture, taken as a whole, had been profitable. The federal income system is based on an annual accounting. Under the law the question whether taxable profits has been made is determined annually by the results of the operation of the year."

See also on this same point *E. E. Healy et al v. Commissioner* 345 U.S. 278 (1953); etc. *U.S. v. Consolidated Edison Company of New York, Inc.* 366 U.S. 380 (1961); *Russell L. Mannette, Jr.* 69 T.C. 990 (1978); *Reis v. Comm.* 142 F2d 900 (6th Cir. 1944); *Brown, C. Maxwell v. U.S.* 224 F2d 845 (6th Cir. 1955); *Burnet vs. Thompson Oil and Gas Company* 283 U.S. 301 (1931); *Woolford Realty Company v. Rose* 286 U.S. 319 (1932); *Brown v. Helvering* 291 U.S. 193 (1934); *Helvering v. Morgan's, Inc.* 293 U.S. 121 (1934); *Guaranty Trust Co. of N.Y. v. Commissioner* 303 U.S. 493 (1938); *Reo Motors, Inc. v. Comm.* 338 U.S. 442 (1950).

Faced with the same problem presented by the Petitioners in these cases, the Seventh Circuit in *Maguire v. Commissioner* 222 F2d 472 (1955) adhered to the principle enunciated by

this Court in observing the essential integrity of each tax year. There the court analyzed the liquidation problem on a year-to-year basis. And see *Estate of William G. Maguire* 50 T.C. 130, 140 (1968), a case involving the estate of the same taxpayer, where the court said, "The question of whether Mokan was in the process of liquidation in 1960 is a continuing or recurring factual question; that is, for the purpose of determining the proper tax treatment of the distributions received by Mokan stockholders, it is necessary to decide each year whether Mokan was in the process of liquidation." The correctness of this interpretaion of Section 346(a)(1) is further supported by the opinions in *Fowler Hosiery Co.* 36 T.C. 201 (1961), aff'd 301 F2d 394 (7th Cir. 1962); *R. D. Merril Co.* 4 T.C. 955 (1945); *Rollestone Corporation* 38 B.T.A. 1093 (1938); *Estate of Charles Fearon* 16 T.C. 385 (1951); *T. T. Word Supply Co.* 41 B.T.A. 965 (1940).

The clear implication and foundation for the opinions of the Courts below in these cases is that Section 346(a)(1) requires the consummation of the plans of complete liquidation. If this conclusion were true then it would appear that the liquidation would come under the purview of Section 331(a)(1), not Section 346(a)(1), and Section 346(a)(1) is nothing more than a redundancy in the statutory scheme. One of our leading tax commentators supports this conclusion:

"A complete liquidation of a corporation can apparently exist only where the definition of partial liquidation does not apply, since otherwise there would be no purpose in distinguishing between complete and partial liquidation as defined in Section 346(a)(1) . . . ." Mertens, *Law of Federal Income Taxation* Vol. 1, Chap. 9, p. 188, sec. 9.68.

The Sixth Circuit's and District Court's opinions, orders and judgments in retroactively changing the characterization of a taxable transaction in one taxable year because of circumstances existing in subsequent taxable years is clearly contrary to the mandates of this Honorable Court regarding the integrity of each taxable year, is in conflict with the Seventh Circuit and other courts, and makes meaningless the statutory pro-

vision involved. Such considerations should require the granting of the writ.

II

The concept of partial liquidation under Section 346(a)(2) of the Internal Revenue Code of 1954 in determining whether a distribution is "not essentially equivalent to a dividend" embodies the idea of "corporate contraction". This is made clear by the legislative history. *Senate Committee Report* (83d Cong., 2d Sess., S. Rep. No. 1622 (1954) 261). Congress does not attempt to define the nature or extent of the contemplated "corporate contraction" necessary to qualify as a partial liquidation under this subsection and despite an over forty year history of the subsection and its predecessors, the courts have been of little assistance.

The Sixth Circuit in its opinion filed January 13, 1975 (508 F2d 1251 and appendix) basically measures contraction by the percentage reduction in the net worth of the corporations and essentially gives no weight to the nature of the transactions giving rise to the distributions. See also *Estate of Charles D. Chandler* 22 T.C. 1158 (1954), aff'd, 228 F2d 909 (6th Cir. 1955).

The Second Circuit to the contrary would put the emphasis on the nature of the transaction giving rise to the distribution. This position is articulated in the following quotation from *McCarthy v. Conley* 341 F2d 948 (2nd Cir. 1965);

"The transaction in question was clearly not a vertical liquidation which chopped off a part of the productive resources of the enterprise. That portion of corporate capital remained intact. It was a horizontal slice off the top of a nest egg of securities accumulated from past earnings and profits which did not in any degree impair the business activities of the enterprise as they had been carried on before."

Thus, the Sixth Circuit would find a corporate contraction if the percentage reduction in net worth were significant enough even though such reduction resulted only from distri-

butions of earnings and profits, a "horizontal slice off the top of a nest egg". Conversely, the Second Circuit would look to a vertical contraction to determine the degree of impairment to the business activities as they had been carried on beforehand.

Petitioners assert that the disposition of a productive, profitable operating segment of a business is a more reasonable indicia of "corporate contraction" than the percentage reduction in the net worth of a company. The book value of operating assets of Gooding Amusement Co. declined by almost $200,000.00 and book value of net worth reduced almost $1,000,000.00 after the sale of Gooding's Million Dollar Midway. (See Finding of Fact 31 in the District Courts Opinion and Order filed June 21, 1976, appendix).

There is a compelling need in the business community for some realistic, reliable, and definable standards regarding the concept of "corporate contraction" insofar as this measure is used in determining the existence of a partial liquidation for federal tax purposes. The writ should be granted on this issue.

III

Pursuant to Treas. Reg. § 1.346-1(c)(2) the Sixth Circuit applies Treas. Reg. § 1.355-1(c) in making its finding that Gooding's Million Dollar Midway (Southern Route) was not a "trade or business."

This finding is in direct conflict with *H. Grady Lester, Jr.* 40 T.C. 947 (1963) a case in which Respondent as a matter of national tax policy, has acquiesced 1964-2 Cum. Bull. 6.

The Tax Court found in *Lester* that the corporate activity of selling auto parts to dealers as a "jobber" was a separate trade or business from its selling auto parts to other "jobbers", despite the fact that both activities used the same inventories and employees, had no separate books and records; operated out of the same facility; and were subject to common management. Every element relied on by the Sixth Circuit in finding

Gooding's Million Dollar Midway was not a separate trade or business was existent in the Lester case. Yet the Tax Court states ". . . we do not think the fact that the two activities may have been conducted by the same company at the same location and with the same employees, and that the income and expenses of each were not separately reflected in its books and records, makes the two activities any less two separate businesses under the above definition (Reg. § 1.355-1(c)) than if they were conducted entirely separately as they were here after the distribution."

The decision below, is also in conflict with the Tax Court's decision *Marne S. Wilson* 42 T.C. 914 (1964) reversed on other grounds 353 F2d 184, (9th Cir. 1965), where the Tax Court held the financing of retail furniture sales to be a separate trade or business from the furniture sales operation itself, despite integration of location, personnel, records, management and advertising.

It is submitted that the court below has opted for a "superficial" rather than "functional" construction of the term "business" as defined by Treasury Reg. § 1.355-1(c); *Hanson v. U.S.* 338 F. Supp. 602 (D. Mont. 1971).

The Sixth Circuit appears to be saying in these cases that almost any degree of participation in or control of non day-to-day, out of season, business operations by general management is sufficient to defeat any portion of a corporation's business activity from being considered a separate "trade or business."

To the extent these regulations allow such a constrictive and parochial interpretation of a trade or business they most certainly "are so broadly drawn that they may in some instances defeat the Congressional purpose." *Rafferty et al v. Commissioner* 452 F2d 767 (1st Cir. 1971). In fact, the Sixth Circuit in *King et al v. Commissioner* 458 F2d 245 (6th Cir. 1972) would seem to echo this sentiment.

The writ should be granted to impart some realistic standard in interpretating what constitutes a trade or business for

partial liquidating purposes.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

DONALD L. MAINS, and JOYCE G. MAINS, Plaintiffs	:	
vs.	:	Civil Action 71-126
UNITED STATES OF AMERICA, Defendant	:	
F. E. GOODING, Plaintiff	:	
vs.	:	Civil Action 71-127
UNITED STATES OF AMERICA, Defendant	:	

OPINION AND ORDER
(Filed January 15, 1974)

Plaintiffs in these consolidated actions seek refunds totaling $113,603.65 in federal income taxes for the year 1966 and statutory interest.

This matter is before the Court on the complaints filed by the plaintiffs Floyd Gooding, Donald L. Mains and Joyce G. Mains, the answer filed by the defendant and briefs of the parties.

This action was commenced under the provisions of Title 26, United States Code, Section 7422. The Court has jurisdiction over the subject matter of this action under the provisions of Title 28, United States Code, Section 1346. This matter was tried to the Court.

Plaintiffs contend that certain distributions received by them in 1966 as stockholders of the Gooding Amusement Company, Inc. and Thrills Unlimited, Inc. qualified as amounts received as the result of a partial liquidation pursuant to Section 346 of the Internal Revenue Code, and were therefore taxable at the capital gains rate. The government denies that the transactions in question qualified as partial liquidations and contends that the distributions were taxable as ordinary dividend income.

Pursuant to Rule 52 of the Federal Rules of Civil Procedure, The Court makes the following findings of fact and conclusions of law.

Findings of Fact

1. Plaintiff Floyd E. Gooding was the owner of 64.3 percent of the stock of the Gooding Amusement Company, Inc. He also owned 60 percent of the stock of Thrills Unlimited, Inc. In addition to being the controlling stockholder of both corporations, Gooding was also the chief operting officer of both corporations. Gooding died on August 14, 1972 and his estate has been substituted as a party to this action.

2. Plaintiff Joyce G. Mains is the daughter of Floyd Gooding. She owned 16.6 percent of the stock of Gooding Amusement and 35.7 percent of the stock of Thrills Unlimited during the tax year in question.

3. Gooding Amusement was engaged in the carnival business. The company was incorporated in 1946 but it had been operating as a partnership or proprietorship since the early 1930's. The company would contract with various fairs, expositions and shows to provide rides, entertainment and concessions. Each contract would provide for a specified playing date or dates at that particular event. The company had approximately 180 such contracts located primarily in the midwest.

4. For operational purposes, Gooding Amusement was divided into ten field units during the April to November carnival season. Each unit covered a designated route. A

route consisted of a series of fairs or carnivals at which Gooding Amusement had obtained a contract. This organizational arrangement enabled the company to operate at several different locations on the same day. The units were interchangeable in that personnel and equipment were transferred from unit to unit as the need arose and occasionally several units combined to play a large event.

5. While Gooding Amusement did have ten operational field units, all important management functions were performed at the headquarters of the company in Columbus, Ohio. This home office paid the privilege deposits[1] for each unit, bought most of the tickets and advertising for all of the units, kept the books of account and payroll records for all of the units, purchased all of the company equipment and negotiated most of the contracts. During the winter months all of the equipment from each of the units was stored in a common area. The expenses of repair and storage were not allocated to each unit. Finally, the company did not separately determine the profit or loss of each individual unit and it did not prorate its home office expenses among the ten units.

6. Thrills Unlimited was incorporated in 1957. The company was organized to hold title to some of the larger and therefore potentially more dangerous rides used by Gooding Amusement. Thrills would "book on" or lease these rides to Gooding Amusement in exchange for a percentage of the gross receipts received from their operation. The essential management operations of Thrills were performed at the company headquarters. Thrills did not keep separate records for each ride.

7. By far the most profitable of the ten operational units of Gooding Amusement was unit 3. This unit was referred to internally as the "Southern Route" and advertised as "Gooding's Million Dollar Midway." The Southern Route would commence operations in August in Pennsylvania and play at several large fairs located primarily in the south until the end of its season

[1] The privilege deposit was a fee posted in advance by Gooding Amusement with the carnival or fair for the right to cover that particular event.

in early November. Prior to August, unit 3 would participate in playing several other dates consisting primarily of shopping centers and church bazaars that were part of other routes. The general manager, permanent employees and equipment of the Southern Route would join this unit in August.

8. Gooding Amusement first acquired contracts in the south in 1952 after it hired Hal Eifort as a general manager. Eifort brought with him several contracts in the south. Gooding provided Eifort with a nucleus of five rides which Eifort used on the Southern Route. Over the years other contracts were added to the original ones and some contracts were lost to competitors. However, in comparison to the other nine routes, the playing dates on the Southern Route remained more or less the same from year to year.

9. During the period August 1, 1965 through July 31, 1966 the Southern Route grossed $1,219,684.73, or 38.65 percent of Gooding Amusement's total gross income of $3,155,522.68. However, it also produced 47.91 percent of the company's expenses. The Southern Route had an average daily gross of $14,520.05 while the remaining routes had an average daily gross of $1,585.48. The Southern Route had only 84 playing days while the other nine routes had a total of 1221 playing days.

10. The degree of independence enjoyed by the Southern Route prior to 1966 is disputed by the parties.[2] However, the Southern Route was insured under the same insurance policy as the rest of the company and all business records and profits were ultimately sent to the home office of Gooding Amusement. The Southern Route used the Gooding Amusement bank account in Columbus. In addition, as noted above, Gooding Amusement did not keep separate records for any unit. Eifort did have almost complete control over the day to day operations of his unit while he was traveling his route.

[2] The conflicts in testimony involved in this dispute will be discussed more fully below.

Apparently other route managers had similar control but, since most of the other routes were located in the midwest, Gooding took a much more active role in supervising their operations as compared to the operations of the Southern Route. Gooding also believed that Eifort was experienced enough to manage the route without active supervision.

11. Each route including the Southern Route had a small nucleus of rides and personnel. Gooding Amusement also had a small permanent management staff in Columbus. The remainder of the company employees were basically transients who were hired by each unit as the need arose. In addition, even though Gooding Amusement owned over one hundred rides divided among the ten units, each unit would frequently "book on" or lease other rides as the need arose.

12. The Southern Route apparently had more permanent employees than any of the other routes. In fact, many of these employees were employed during the off season by another corporation controlled by Gooding. However, this unit also hired temporary employees as the need arose or leased additional rides.

13. As noted above, rides and personnel were frequently shifted from unit to unit. However, the Southern Route had some large equipment that was used exclusively by it. In addition, the small permanent staff of the Southern Route apparently did not work with any other unit.

14. Gooding had a heart attack in 1964. As a result, Gooding decided to sell both Gooding Amusement and Thrills. On March 16, 1966 Gooding entered into an agreement to sell the Southern Route to a group headed by Milton Kaufman. On April 5, 1966 both Thrills and Gooding Amusement adopted plans of complete liquidation pursuant to Section 337 of the Internal Revenue Code. The next day, Gooding Amusement signed a contract to sell the Southern Route to Gooding's Million Dollar Midway, Inc., a Delaware corporation whose principal was Milton Kaufman, for $350,000.00.[3] At the

[3] This figure does not include a $36,300.00 reimbursement for privilege deposits previously made by Gooding Amusement for contracts on the Southern Route.

same time, Thrills signed a contract to sell a "Mad Mouse" ride to the same corporation for $25,000.00. The "Mad Mouse" ride had never been used by the Southern Route prior to the sale. After the sale was completed, $363,632.66 was distributed to the shareholders of both corporations.

15. Eifort played a key role in arranging the sale. As part of the deal, he and the permanent staff of the Southern Route left Gooding Amusement to work for the new corporation. Gooding became Chairman of the Board of Directors of the new corporation.

16. The assets sold by Gooding Amusement represented only 5.19 percent of the total net worth of the company. The assets sold by Thrills represented only 1.41 percent of its total net worth. At the time of the sale, Gooding Amusement had undistributed profits or earned surplus of $1,335,000.00. However, during the year of the sale, the company paid cash dividends totalling only $8,540.00 to its shareholders in addition to the distribution made as a result of the sale. Similarly, Thrills had undistributed profits of $215,124.83 but paid dividends of only $2,100.00 to its shareholders in addition to the distribution made as a result of the sale.

17. The financial records of both corporations from the date of sale through 1971 do not reflect a redemption of stock by the shareholders arising out of the sale of the Southern Route and "Mad Mouse" ride. Rather, the financial records of both corporations indicate that the amount of the distribution was charged against the earned surplus account and not the capital stock account. The financial records of Gooding Amusement for the year ending August 31, 1972 do indicate that a redemption took place in a prior year.

18. In addition to purchasing the Southern Route and Mad Mouse ride, the buyers were given an option to purchase the balance of both corporations within one year. This option was not exercised and, in fact, the buyers of the Southern Route regarded the rest of both corporations as a poor investment because of their low profit margins. Gooding Amusement and Thrills have continued to operate from the date of the

sale and, to date, the remainder of both corporations have not been sold.[4]

19. After it became apparent that the buyers of the Southern Route had decided not to purchase the remainder of both corporations, the plans of complete liquidation for both corporations were amended to plans of partial liquidation.

20. In the year of the sale, Gooding Amusement purchased new equipment for an amount in excess of $100,000.00 while Thrills purchased new equipment worth approximately $57,000.00. In addition, Thrills purchased additional equipment worth approximately $92,000.00 during the next two years. The Thrills purchases were made pursuant to a plan of expansion adopted prior to the date of the sale of the Mad Mouse ride.

Discussion

A distribution of property to a stockholder by a corporation with respect to his stock must be treated as a dividend to the extent of the earnings and profits of the corporation. 26 U.S.C. §§ 301, 316. One exception to this general rule is Section 331. Under that section, amounts received by a stockholder as the result of a partial liquidation of a corporation are treated as the proceeds of a sale of his stock. Therefore, any gain which the stockholder recognizes as a result of the distribution will be capital gain and not ordinary income if the stock was a capital asset in his hands.

The term partial liquidation is defined in Section 346:

> (a) In general. — For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if —
>
> > (1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to plan; or

[4] Currently, an unrelated corporation holds an option to purchase both Gooding Amusement and Thrills. To date, this option has not been exercised and it may never be exercised.

> > (2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).
>
> . . .
>
> (b) Termination of a business. — A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.
>
> > (1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.
> >
> > (2) Immediately after the distribution is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.
>
> Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.
>
> (c) Treatment of certain redemptions. — The fact that, with respect to a shareholder, a distribution qualifies under section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock) by reason of section 302 (b) shall not be taken into account

> in determining whether the distribution, with respect to such shareholder, is also a distribution in partial liquidation of the corporation. . . .

The only question which must be answered in this case is whether the sale of the Southern Route and Mad Mouse ride by Gooding Amusement and Thrills qualified as partial liquidations within the meaning of Section 346. The commissioner determined that the transaction did not qualify as a Section 346 partial liquidation. This determination is presumed to be correct and the taxpayer has the burden of proof to overcome the presumption.

I

A distribution qualifies as a partial liquidation under Section 346 (a) (2) if it:

(1) "is not essentially equivalent to a dividend";

(2) is in redemption of a part of the stock of the corporation pursuant to a plan; and

(3) occurs within the taxable year in which the plan is adopted or within the succeeding tax year.

The second and third elements of this test are basically mechanical in that an examination of the corporate records will generally reveal whether or not the taxpayer has satisfied them. However, the question of whether a distribution is "Not essentially equivalent to a dividend" is far more difficult to resolve. Unfortunately, neither the statute nor the regulations thereto define this phrase. The regulations to Section 346 state:

> . . . An example of a distribution which will qualify as a partial liquidation under subparagraph (2) of this paragraph and section 346 (a) is a distribution resulting from a genuine contraction of the corporate business such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities. On the other hand, the distribution of funds attributable to a reserve for an expansion program which has been abandoned does not qualify as a partial liquidation within the meaning of section 346(a) . . . . Treas. Reg. § 1.346-1 (1955).

The concept of corporate contraction originated in cases decided under Section 115 (g) of the Internal Revenue Code of 1939. Section 115 (i) of the 1939 Code defined the term partial liquidation to include a distribution made by a corporation in complete cancellation or redemption of a part of its stock. Under Section 115 (g) (1), any redemption of a part of the stock of a corporation which was not "essentially equivalent to the distribution of a taxable dividend" was treated as a partial liquidation. Some cases interpreting this language held that if there was a genuine contraction in a corporation's business then that corporation could distribute in liquidation to its shareholders the assets no longer required by the corporation because of the contraction. *See, e.g., Sullivan v. Commissioner,* 17 T.C. 1420 (1952), *aff'd.* 210 F.2d 607 (5th Cir. 1954); *see also* 1 Mertens, Law of Federal Income Taxation § 9.69. Another line of cases held that Section 115 (g) was inapplicable where the stockholder's interest in the corporation was completely terminated or disproportionately reduced as a result of a distribution. *See, e.g., Johnson, Carvell & Murphy v. Riddell,* 173 F.Supp. 214 (S.D. Calif. 1959); *see also* 1 Mertens, Law of Federal Income Taxation § 9.69.

The primary problem with the concept of partial liquidation as it existed under the 1939 Code was that under Section 115 all distributions were treated the same regardless of whether they had an effect at the stockholder level or at the corporate level. The Senate Committee which studied the draft of the 1954 Code commented on the problems created by Section 115:

> . . . Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in a capital-gain treatment to the redeemed shareholder. The result occurs, however not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed

> at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend. . . . 3 U.S. Code Cong. & Ad. News 4680 (1954).

Congress attempted to solve this problem by changing the definition of partial liquidation. A partial liquidation is now defined solely in terms of what happens at the corporate level.

Section 346 (a) was added by the Senate to the House bill. The Senate Committee report on this section stated that:

> . . . Subsection (a) is intended to provide a definition of partial liquidation which replaces that contained in section 115 (i) of the 1939 Code. Primarily, this definition involved the concept of "corporate contraction" as developed under existing law. A distribution shall be treated as in partial liquidation if it is one of a series in redemption of all of the stock of a corporation pursuant to a plan or if the distribution is not essentially equivalent to a dividend and is in redemption of a part of the stock of a corporation pursuant to a plan of partial liquidation and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.
>
> It is intended that a genuine contraction of the business as under present law will result in partial liquidation. See, for example, Joseph Imler (11 T.C. 836). However, a distribution of a reserve for expansion is not a partial liquidation. . . . 3 U.S. Code Cong. & Ad. News 4899 (1954).

Another section of the Senate Committee report gives an example of a case involving a corporate contraction:

> . . . The general language of the proposed draft would include within the definition of a partial liquidation the type of cases involving the contraction of the corporate business. Such as for example, cases which hold that if the entire floor of a factory is destroyed by fire, the insurance proceeds received may be distributed pro rata to the shareholders without the imposition of a tax at the rates applicable to the distribution of a dividend, if

> the corporation no longer continues its operations to the same extent maintained by the destroyed facility. Voluntary bona fide contraction of the corporate business may of course also qualify to the same extent as under existing law. . . . 3 U.S. Code Cong. & Ad. News 4899 (1954).

The legislative history of Section 346 (a) (2) indicates that the most important factor to be considered in determining whether or not a transaction qualifies as a partial liquidation under 346 (a) (2) "is whether there has been a contraction in the business of the corporation." *Ballenger v. United States*, 301 F.2d 192, 195 (4th Cir. 1962). However, this factor is not the only factor which must be examined since "many distributions which contract the size of a corporation possess the major indicia of a dividend distribution . . . ." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders § 9.52, p. 9-50 (3d ed. 1971).

Therefore, after determining whether or not a corporate contraction has taken place, courts have also examined the following factors:

1. The net effect of the transaction.
2. The presence or absence of a bonda fide corporate business purpose.
3. Whether the action was initiated by the stockholders or by the corporation.
4. The size of the corporate earned surplus.
5. The amounts, frequency and significance of the dividends paid by the corporation in the past.
6. Whether there were any special circumstances relating to the distribution.

See Imler v. Commissioner, 11 T.C. 836 (1948); *Herman v. Commissioner*, 283 F.2d 227 (8th Cir. 1960); *United States v. Carey*, 289 F.2d 531 (8th Cir. 1961).

Whether there has been a genuine corporate contraction depends upon the facts and circumstances of each case. The

assets sold by Gooding Amusement represented only 5.19 percent of the net worth of the company while the assets sold by Thrills represented only 1.41 percent of its net worth. One court, citing an American Law Institute study, has held that a corporation must sell at least 50 percent of its net worth before a distribution of the proceeds of the sale to the stockholders could qualify under Section 346 (a) (2). *McCarthy v. Conley*, 229 F.Supp. 517 (Conn. 1964), *aff'd.* 341 F.2d 948 (2d. Cir. 1965).

While the Court does not find it necessary in this case to adopt an arbitrary percentage test, the Court does believe that a corporation must sell a significant percentage of its net worth and distribute the proceeds of the sale to its stockholders before the transaction can qualify as a Section 346 (a) (2) partial liquidation. The Court does not believe that 5.19 percent of Gooding Amusement's net worth and 1.41 percent of Thrills' net worth represented a significant percentage of either corporation's net worth. In addition, the Court notes that each corporation purchased a large amount of new equipment after the sale. The net result of these new purchases was that the value of both corporation's operating assets remained basically the same. *See* Rev. Rul. 67-299, 1967-2 Cum. Bull. 138. Finally, the Court does not believe that the sale of the Southern Route or the Mad Mouse ride substantially reduced the business activity of either corporation. While the Southern Route produced a substantial percentage of Gooding Amusement's gross income,[5] the number of contracts served by the Southern Route and the number of playing days it had were small when compared to the activities of the remaining nine units.

A partial liquidation is more than a mere sale of assets by a corporation. The sale must be accompanied by a significant

[5] While the Southern Route produced a substantial percentage of the company's gross income, it also produced 47.91 percent of the company's expenses. Therefore, while other routes were not as profitable they were not as expensive to operate and in fact produced most of the company's net income.

reduction in the corporation's net worth and by a substantial reduction in its business activities.[6] The presence of these factors may establish that a significant event in the life of the corporation has occurred as opposed to a mere sale of now unwanted assets. The Court concludes on the basis of this record that neither corporation genuinely contracted its business as a result of the sale of the Southern Route and Mad Mouse ride.

At the time of the sale, both corporations had comparatively large amounts of accumulated earnings and profits.[7] During past years, both corporations had paid extremely low dividends in comparison to their earnings. In addition, both companies were essentially closely held family corporations. Under these circumstances, a purported partial liquidation must be carefully examined to prevent tax avoidance. This is especially true where, as here, the distributions were pro rata and did not meaningfully reduce any stockholder's proportionate interest in either corporation. *Cf. United States v. Davis*, 397 U.S. 301 (1970). The distributions in this case had the same practical effect as a dividend. In fact, for six years the distributions were treated as a dividend on the corporate records of both corporations. Those records indicate that the distributions were charged against the earned surplus account on both corporations' balance sheets. Under proper accounting procedures, the distributions should have been charged against the capital stock account to reflect the redemption of a portion of the stock. The company accountant who was also on the board of directors testified that the distributions should have been charged against the capital stock account but that a bookkeeping error was made that went unnoticed for six years. The Court finds it difficult to believe that any Certified

[6] Of course, what constitutes a substantial reduction depends upon the facts and circumstances of each case.

[7] For example, Gooding's Amusement balance sheet for the year ended August 31, 1966 shows total assets of $1,942,462.30 and earned surplus of $1,364,453.03.

Public Accountant could overlook such an obvious and fundamental mistake for six years. The Court believes that the distributions in this case were essentially equivalent to a dividend and were in fact treated as dividends on the corporate books. Therefore, the transaction does not qualify as a Section 346 (a) (2) partial liquidation.

II

Under Section 346 (b), a transaction will qualify as a partial liquidation where:

1. Two or more active, separate businesses have been conducted for a minimum of five years.
2. The distribution to the stockholders is attributable to the corporation's ceasing to conduct one of those separate businesses.
3. Immediately after the distribution the corporation continues to conduct its other business or businesses.

This subsection has no counterpart in the 1939 Code. Its authors apparently accepted the corporate contraction test but were concerned about the vague standards applied by the courts. This subsection was therefore specifically drafted to define one situation in which capital gain or loss treatment would be assured. *See* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders § 9.53, p. 9-55 (1971). The requirements of this subsection were carefully drawn to prevent tax avoidance.

Plaintiffs contend that the Southern Route and Mad Mouse ride were separate businesses from their respective corporations within the meaning of Section 346 (b). The term "business" is defined as:

> . . . a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include —
>
> . . .
>
> (3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial. . . . Treas. Reg. §1.355-1 (c) (1955).[8]

The Court initially notes that Gooding Amusement was engaged in the carnival business and that the Southern Route was merely one operational unit of the corporation. Plaintiffs, relying primarily on the testimony contained in the deposition of Hal Eifort, contend that the Southern Route operated completely independent of Gooding Amusement and was, therefore, a separate business. Eifort's testimony by itself somewhat supports plaintiffs' position. However, other testimony in the record indicates that Eifort's operations were merely part of the overall activities of the corporation. The company accountant testified that all essential management functions were performed at the home office of the company in Columbus. The home office paid all significant expenses, posted the privilege deposits for each unit and maintained all permanent records including all tax records. The company did not treat the Southern unit or any other unit as a separate business and commingled all receipts. The Southern Route was not separately insured. Eifort did have almost complete control over his own unit while it was traveling its route and even paid some of his own expenses. This arrangement was necessary simply because of the nature of the carnival business.

[8] The regulations to Section 346 state that the term "active conduct of a trade or business" is defined in the regulations to Section 355.

Finally, the Court notes that during the off season all of the rides from each of the units were stored in a common area.[9]

On the basis of this record, the Court does not believe that the Southern Route included every operation which formed a part of, or a step in, the process of earning income or profit. In addition, the Southern Route did not pay all of its own expenses and was not treated as a separate business on the corporate books. *See Blaschka v. United States*, 393 F.2d 983, 990-992 (Ct. of Claims 1968).[10] The Court therefore concludes that the Southern Route was not a separate business within the meaning of Section 346 (b).

The Mad Mouse ride was merely one of the rides owned by Thrills and leased to Gooding Amusement. All essential corporate records were kept by the company and the Mad Mouse ride was not treated as a separate business on these records. All essential management functions were performed at the company headquarters.

The Mad Mouse ride was not used by the Southern Route prior to its sale. In fact, the record does not indicate where and by whom this ride was used during the years prior to its sale. The Court therefore concludes that the Mad Mouse ride was not a separate business within the meaning of Section 346 (b).

[9] Eifort testified in his deposition that his equipment was kept in a special location during the off season. However, the company accountant specifically testified that each unit stored its equipment in a common place. This testimony is consistent with other testimony in the record and is more credible. The Court therefore believes that the equipment for the Southern Route was stored with all of the rest of the company equipment in a common area during the off season.

[10] The Blaschka case also stressed the importance of the amount of income generated by the allegedly separate business. In this case, the Southern Route generated a substantial amount of income. However, this fact by itself is not necessarily determinative of the issue. Other factors such as who manages the allegedly separate business and who pays its expenses must also be carefully examined.

III

In their post trial brief, plaintiffs contend that the transaction in question qualifies as a partial liquidation under the provisions of Section 346 (a) (1). The government has filed a motion to strike this contention because this issue was never raised in plaintiffs' claims for refund, in the final pretrial order or at the trial itself.

The final pretrial order lists the following issues of fact and law:

> Whether the distributions in question qualify as partial liquidations under Section 346 (a) (2) or Section 346 (b) of the 1954 Internal Revenue Code.
>
> In the case of Section 346 (a) (2), qualification depends upon whether plaintiffs can establish that the distributions were "not essentially equivalent to a dividend."
>
> In the case of Section 346 (b) qualification depends upon whether plaintiffs can establish that the distributions were attributable to the termination of an "actively conducted . . . trade or business" within the meaning of that section.

The final pretrial order was prepared by counsel for the parties and approved by the Court. The statement of issues in the order does not mention Section 346 (a) (1).

One of the purposes of a pretrial order is to narrow and define the issues in a case. The final pretrial order does not raise the question of whether the transaction qualified as a partial liquidation under Section 346 (a) (1). Therefore, this issue, which has not been briefed by the government, is not properly before the Court.[11] *Morrocco v. Northwest Engineering Company*, 310 F.2d 809 (6th Cir. 1962); *Cornish v. United States*, 221 F.Supp. 658, 666 (Oregon 1963), *rev'd on other*

[11] In any event, the sales in question would not qualify as a partial liquidation under Section 346 (a) (1) in that there has been no *series* of distributions in redemption of *all* of the stock of the two corporations.

grounds 348 F.2d 175 (9th Cir. 1965); *Fleming v. Ayoud*, 206 F.Supp. 860, 864 (D.C. 1962); *aff'd. on other grounds* 315 F.2d 47 (D.C. Cir. 1963).

A careful examination of the trial transcript does not indicate that the government impliedly consented to place this issue in the case. In view of this conclusion, the Court finds it unnecessary to consider whether plaintiffs raised this issue in their claims for refund.

Conclusions of Law

1. The Court has jurisdiction over the subject matter of this action under the provisions of Title 28, United States Code, Section 1346 (a) (1).

2. The sale of the Southern Route by Gooding Amusement was not a partial liquidation within the meaning of Section 346 (a) (2) or Section 346 (b).

3. The sale of the Mad Mouse ride by Thrills was not a partial liquidation within the meaning of Section 346 (a) (2) or Section 346 (b).

4. The distributions received by plaintiffs were properly taxed as ordinary income.

5. Plaintiffs may not raise an issue in their post trial brief not listed in the final pretrial order.

WHEREUPON, the Court determines that judgment should be and hereby is entered for the defendant, United States of America.

/s/ JOSEPH P. KINNEARY
Chief Judge
United States District Court

No. 74-1469

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

DONALD L. MAINS and JOYCE G. MAINS,
Plaintiffs-Appellants,
v.
UNITED STATES OF AMERICA,
Defendant-Appellee.

F. E. GOODING,
Plaintiff-Appellant,
v.
UNITED STATES OF AMERICA,
Defendant-Appellee.

APPEAL from United States District Court for the Southern District of Ohio.

Decided and Filed January 13, 1975.

Before WEICK and ENGEL, Circuit Judges, and O'SULLIVAN, Senior Circuit Judge.

WEICK, Circuit Judge. The suits in the District Court were for refund of federal income taxes paid for the year 1966 by taxpayers Donald L. and Joyce G. Mains, in the amount of $8,025.01, plus interest, and by taxpayer F. E. Gooding in the amount of $105,578.64, plus interest. Claims for refund had been timely filed and were disallowed.

The cases were consolidated for trial and were heard by the District Court without a jury. The District Court, in a written opinion, held that distribution of the entire proceeds of sale of a portion of the capital assets of Gooding Amuse-

ment Company, Inc. and Thrills Unlimited, Inc., amounting to $363,632, made to the shareholders of the corporations, was not entitled to capital gain treatment under § 331 of Title 26 of the Internal Revenue Code as being made in partial liquidation of the corporations, but was dividends properly taxable as ordinary income.[1] 372 F.Supp. 1093 (S.D. Ohio, 1974). Judgment was entered in favor of the Government, and taxpayers appealed.[2]

Mr. Gooding owned 64.3% of the stock of Gooding Amusement, 60% of the stock of Thrills Unlimited, both Ohio corporations, and was the chief executive officer of said corporations. Mr. Gooding's daughter, Joyce G. Mains, owned 16.6% of the stock of Gooding Amusement, and 35.7% of the stock of Thrills Unlimited. Donald Mains is the husband of Joyce G. Mains.

Gooding Amusement was engaged in carnival business, contracting with fairs, trade shows, and expositions to provide rides and other forms of entertainment. Thrills Unlimited was incorporated to own certain large, dangerous rides, and to lease them to Gooding Amusement for a percentage of the gross receipts.

Gooding Amusement was divided into ten operating units, of which the most profitable was unit number three, called the "Southern Route." In the year ending July 31, 1966 the Southern Route provided 38% of the gross income of Gooding Amusement, and 47.91% of its expenses.

In contrast to the other units, the Southern Route had some equipment which was used exclusively by it; and its

[1] Both corporations had accumulated earnings and profits exceeding the amount of the distribution made by the respective corporations. Under IRC § 331(a)(2) distributions made in partial liquidation of a corporation are treated as made in part or in full payment in exchange for the stockholder's stock. If the stock qualifies as a capital asset in the stockholder's hands, any gain is capital gain.

[2] F. E. Gooding died on August 14, 1972, and his estate was substituted as a party plaintiff to this action.

playing contracts remained almost the same from year to year. The Southern Route's general manager, Hal Eifort, controlled its day to day operation on the road, and was only lightly supervised by Gooding Amusement's home office in Columbus, Ohio.

Gooding Amusement kept its books and records at its home office and had its bank account there for all operations. It purchased all the equipment used by the Southern Route, paid any privilege deposits required by fair boards, and made most of the expenditures required for ticket printing and advertising. However, Mr. Eifort arranged and paid for newspaper advertising for the various playing dates.

During the "off season" all of the rides and equipment were stored in one place on Gooding's property.

On April 5, 1966 Gooding Amusement and Thrills Unlimited adopted plans of complete liquidation pursuant to IRC § 337. The following day Gooding Amusement contracted to sell the Southern Route's equipment, contracts, and trade name to a Delaware corporation for $350,000. Gooding Amusement also agreed not to compete with the purchaser for one year. Concurrently Thrills Unlimited contracted to sell a ride, called the "Mad Mouse," to the Delaware corporation for $25,000. The purchaser was given an option to buy the remaining assets of the two corporations within one year, but it did not exercise the option. The entire proceeds of sale, totaling $363,632, were distributed to the shareholders of the two corporations.

Both corporations filed information returns of said plans pursuant to IRC § 337.

Gooding Amusement and Thrills Unlimited were unable to liquidate within one year and therefore could not avail themselves of the advantages of IRC § 337. On March 24, 1967 they amended their plans of liquidation to plans of partial liquidation. The corporations filed information return forms 966 describing the plans as plans of partial liquidation under IRC §§ 331(a)(2) and 346(a)(2).

The corporations had substantial accumulated earnings and profits and liquid assets.[3] Although their incomes were substantial, dividends were relatively small.

Because of the ill health of Mr. Gooding the corporations later entered into a management contract with an unrelated corporation, including an option to purchase the stock or assets. While this appeal was pending the option was exercised, according to statements in appellants' reply brief.

Distributions by a corporation to its shareholders receive ordinary income treatment under IRC §§ 301 and 316, assuming adequate earnings and profits, unless the Internal Revenue Code provides otherwise. One of the exceptions is a distribution made in partial liquidation of a corporation. IRC § 331(a)(2). "Partial liquidation" is defined in IRC § 346 which is set out in relevant part in footnote 4. The District Court concluded that the distributions were not made in partial liquidation of the corporations pursuant to IRC §§346(a)(2) and 346(b). The Court held that the pretrial order in the case precluded consideration of IRC § 346(a)(1), but stated in a footnote that the distributions could not qualify under that subsection in that there had been no series of distributions in redemption of *all* of the stock of the two corporations. 372 F.Supp. 1093, 1104, n.11.

[3] On August 31, 1966, after Gooding Amusement had distributed $346,009 as a partial liquidating dividend, and $8,540 as an ordinary dividend, it had earned surplus of $1,364,453 and current assets and investments of $1,177,350. Total assets were $1,942,462. A similar situation, albeit on a smaller scale, obtained with Thrills Unlimited.

[4] Section 346. Partial Liquidation Defined.

(a) IN GENERAL.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562(b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) TERMINATION OF A BUSINESS.—A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

There is no question as to this Court's standard of review. A District Court finding that a distribution was not made in partial liquidation, but was essentially equivalent to a dividend, is a finding of fact which cannot be disturbed unless it is clearly erroneous or was induced by an erroneous view of the law. *United States* v. *Carey*, 289 F.2d 531, 537 (8th Cir. 1961); *Estate of Chandler* v. *Commissioner*, 228 F.2d 909 (6th Cir. 1955).

We will now consider the sections of the Internal Revenue Code which taxpayers claim require capital gains treatment.

I

IRC § 346(a)(2)

The only requirement of § 346(a)(2) which is in issue is whether the distributions by the corporations were "not essentially equivalent to a dividend." According to the legislative history of the section, qualification under this subsection depends primarily on the existence of a bona fide corporate contraction. Such a corporate contraction qualifies to the same extent as under previous law. 3 1954 U.S. Code Cong. & Ad. News. p. 4680, 4899.

From the stockholder's point of view a pro rata distribution in partial liquidation of a corporation is similar to an ordinary dividend. Distributions in partial liquidation are "characterized by what happens solely at the corporate level . . . ." 3 1954 U.S. Code Cong. & Ad. News, at 4680, although §§ 331 and 346 are concerned with the tax treatment of the shareholder.

Because a distribution qualifying under § 346(a)(2) possesses many of the characteristics of a dividend taxed at ordinary income rates, the sale or distribution of assets claimed to constitute a corporate contraction must be a significant event in the history of the corporation if sale or distribution of assets is not to become a convenient pretext for bail-out of earnings and profits at capital gain rates.[5] Bittker & Eustice, Fed. Income Taxation of Corporations & Shareholders, ¶ 9.52, 3d Ed.

The District Court held that the sale and distribution was not a §346(a)(2) contraction. The Court stated that a corporation must sell and distribute a significant percentage of its net worth, and that the percentages attributable to the sales of the Southern Route and the Mad Mouse, 5.19% and 1.41% respecively, were not significant. In addition the Court stated that purchases of new equipment after the sale, by the two corporations, resulted in no real contraction at all, and that business activity, measured by the number of playing days, was not appreciably affected.

The taxpayers contend that this Court should not regard Thrills Unlimited as having a corporate existence separate from Gooding Amusement for purposes of determining the applicability of § 346(a)(2) to distributions made by Thrills

[5] One justification offered for distinguishing the tax treatment given distributions in partial liquidation after a corporate contraction from the tax treatment of ordinary dividends, is that in the case of a corporate contraction and distribution "the stockholders no longer retained a continuing interest in the *same* business but rather in a materially reduced one." 1 Mertens, Law of Fed. Income Taxation, § 9.69. This rationale contemplates that the contraction is a significant event in the history of the corporation.

Unlimited. They argue that Thrills Unlimited's only business was to lease equipment to Gooding Amusement, and therefore its fortunes were tied closely to the fortunes of Gooding Amusement. However, the taxpayers offered no evidence that Thrills Unlimited and Gooding Amusement were not treated as two distinct corporations. Thrills Unlimited was not a subsidiary of Gooding Amusement, and Gooding Amusement had a number of shareholders who were not shareholders of Thrills Unlimited. Distributions from Thrills Unlimited must qualify independently, if they qualify at all.

The District Court found that Thrills Unlimited purchased new equipment in the year of the sale and during the following two years for amounts totaling approximately $149,000, about six times the sale price of the Mad Mouse, and that Thrills Unlimited was engaged in a plan of expansion. These findings are supported by the evidence. Doris Relyea testified concerning equipment purchases made by Thrills Unlimited, and admitted writing a letter to the Internal Revenue Service to justify the accumulation of earnings and profits in Thrills Unlimited, stating that Thrills had plans to expand.

It is clear that in the year of the sale and during the years immediately following, Thrills Unlimited expanded its commitment of capital to equipment. In order for a distribution to qualify as a distribution in partial liquidation under § 346(a)(2) the amount of capital actually committed to the corporate business must be significantly reduced. Rev. Rul. 67-299, 1967-2 Cum. Bull. 138; *Estate of Charles D. Chandler*, 22 T.C. 1158, 1166 (1954), *aff'd*, 228 F.2d 909 (6th Cir. 1955).

Although a sale or other disposition of assets may be a potential corporate contraction, there is no contraction if funds are used to expand another part of the business so that the potential contraction is offset.

The book value of the equipment sold by Gooding Amusement as the Southern Route was $98,237. During the fiscal year of the sale it purchased $100,740 of new equipment. The

taxpayers point out that Gooding Amusement purchased some equipment every year to replace old equipment, and they assert that even after a plan of liquidation was adopted such purchases were necessary to maintain the company's contracts and goodwill.

Purchases were $77,702 in 1965 and $62,173 in 1964 fiscal years. An examination of Gooding Amusement's balance sheets indicates that the company did not expand its capital commitment to productive assets prior to 1966.

Where a corporation regularly replaces worn equipment, purchases of such equipment in amounts not substantially exceeding previous years' purchases should not be regarded as an expansion of the busines. However, Gooding Amusement purchased equipment in 1966 which exceeded that purchased in the years immediately preceding. At least to the extent of a substantial increase in the amount spent for purchases of equipment, the District Court can consider such purchases as expansion of the remaining business to compensate for the sale of the Southern Route.

The District Court used a net worth test to determine that there had been no contraction, not taking into account the purchase of new equipment. Determination of whether there exists a corporate contraction must be made on the facts of each case. The relative percentage of the assets sold to the entire net worth of the corporations is only one factor to be considered. Certainly the approximate percentage of the productive assets of the corporation, including working capital, equipment, and inventory, attributable to the assets disposed of, is of basic importance. That percentage must be substantial. Rev. Rul. 67-299, 1967-2 Cum. Bull. 138; *Estate of Charles D. Chandler*, *supra*. See *McCarthy* v. *Conley*, 341 F.2d 948, 955 (2d Cir. 1965).

Considering the increased purchase of equipment and the relatively small fraction of the assets disposed of, the District Court's finding that there was not a contraction is supported by substantial evidence, and is not clearly erroneous.

II

IRC § 346(b)

The only requirement of this subsection that is in issue is that the distribution be "attributable to the corporation's ceasing to conduct . . . a trade or business . . . ." The issue is whether the Southern Route constituted a trade or business. Treas. Reg. § 1.346-1(c)(2) (1955) refers to Treas. Reg. § 1.355-1(c) for a definition of the term "active conduct of a trade or business." Treas. Reg. § 1.355-1(c) (1955), in pertinent part, is as follows:

> . . . [A] trade or business consists of a specified existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Some overlap between the trade or business and the remainder of the corporation must be expected. Rev. Rul. 56-451, 56 Cum. Bull. 208 concerned a corporation which published four trade magazines. The magazines had separate offices, separate editorial and advertising sales staffs, and separate accounts on the books of the corporation. However, the general officers of the corporation and, of more importance, the production workers served all of the magazines. The Internal Revenue Service held that the metal trade magazine was a trade or business separate from the rest for purposes of IRC §§ 355, 361, and 368. See also Treas. Reg. § 1.355-1(d), Example 15.[6]

[6] Separate manufacturing plants owned by one corporation, but having a common sales outlet, are separate trades or businesses. *Blaschka* v. *United States*, 393 F.2d 983, 991 (Ct. Cl. 1968), distinguishes this example. "Each plant was a viable entity, capable of producing the product from beginning to end."

Blaschka v. *United States*, 393 F.2d 983 (Ct.Cl. 1968), identifies two major factors in determining the existence of an actively conducted trade or business. The first requirement is that each of the parts alleged to constitute a trade or business must produce a substantial part of the combined corporate income. The second requirement is that there be some form of separation of supervision and control.

There is no question that the Southern Route provided a large part of the total income of Gooding Amusement. If it was a trade or business it was an actively conducted trade or business. However, the Southern Route did not include every step in the process of earning income. Several important operations were conducted by the home office. The same evidence shows that there was no real separation of control, although the Southern Route's general manager necessarily controlled its day to day operations in the field.

Mr. E. C. Redman testified that privilege deposits were paid by the home office, tickets were bought, and major advertising expenditures, such as for color posters, also were made by the home office. New equipment was purchased by the home office, and the equipment used by all units was stored at a common place, with no apportionment of overhead. This indicates that Mr. Eifort's control of the Southern Route was limited to its operation while it traveled its route, and also that the Southern Route did not pay all of its expenses.

Moreover, Mrs. Relyea testified that during the time of Mr. Gooding's ill health, when Mr. Eifort, by reason of the good relationships that he had built with the fair boards, was negotiating for the Southern Route contracts, she (Mrs. Relyea) sat in on some of the sessions. This shows the existence of lack of separation of supervision, although circumstances made only light supervision necessary.

In our opinion the District Court's determination that the Southern Route did not constitute a separate trade or business, is supported by substantial evidence and is not clearly erroneous.

III

IRC § 346(a)(1)

The District Court held that the final pretrial order precluded reliance by the taxpayers on IRC § 346(a)(1).[7] We disagree.

The first pretrial order provided:

> E. Issues –
>
> Whether or not the items of income received by the plaintiffs for the calendar year ending December 31, 1966 from Gooding Amusement Co. and Thrills Unlimited, Inc. were ordinary dividends or partial liquidation dividends.

There is nothing in this order which limits the taxpayers to any particular section of the Internal Revenue Code.

The final pretrial Order contained in the Appendix, on which the District Court relied, is in relevant part as follows:

> **IV. AGREED STATEMENTS AND LISTS:**
>
> **A. General Nature of the Claims of the Parties**
>
> 1. The plaintiffs claim that distributions received by them in 1966 as stockholders of Gooding Amusement Company, Inc. and Thrills Unlimited, Inc. qualified as partial liquidations under Section 346 of the 1954 Internal Revenue Code.

[7] Despite this holding the District Court in fn. 11 of its opinion, stated:

> In any event, the sales in question would not qualify as a partial liquidation under Section 346(a)(1) in that there has been no series of distributions in redemption of *all* of the stock of the two corporations.

2. The defendant claims that the distributions do not qualify as partial liquidations, in which case they are taxable to the plaintiffs as dividends.

• • •

C. Issues of Fact and Law

Whether the distributions in question qualify as partial liquidations under Section 346(a)(2) or Section 346(b) of the 1954 Internal Revenue Code.

In the case of Section 346(a)(2), qualification depends upon whether plaintiffs can establish that the distributions were "not essentially equivalent to a dividend."

In the case of Section 346(b) qualification depends upon whether plaintiffs can establish that the distributions were attributable to the termination of an "actively conducted • • • trade or business" within the meaning of that section. (A. 17-18)

It will be noted therefrom that A-1. of the Order states the nature of the claim of the taxpayers, that the distributions "qualified as partial liquidations under Section 346 of the 1954 Internal Revenue Code." This would include subsection (a)(1) as well as (a)(2) and (b). The fact that the Government in A-2. did not agree with that claim does not prevent the taxpayers from asserting it.

In the Government's brief the following statement was made:

> This issue was not listed in the pretrial order and indeed, taxpayers' counsel stated at trial that the provisions of Section 346(a)(1) dealing with complete liquidations were not applicable to this case. (p. 14)

It was further stated in the Government's brief:

> Counsel for taxpayers conceded in his opening statement at trial that Section 346(a)(1) was not involved herein stating (I-R. 22):

> The second definition [346(a)(2)] – the first one does not apply in our case since we do not have a complete liquidation – which is the one that the case revolves about • • •.
>
> After denying this was an issue in the case and after all the evidence had been introduced on that basis, taxpayers turn about and raise the issue for the first time in their post-trial brief. (p. 37).

An examination of the court reporter's transcript of opening statements of counsel reveals that the above statements attributed (in the Government's brief) to taxpayers' counsel, were not made by him, but on the contrary they were made by Mr. Thomasch, who was counsel for the Government.

The opening statement of counsel for the taxpayers contained, among others, the following statements:

> [7] • • • The Internal Revenue Code sections that we are immediately concerned with are Sections 331 and 346 of the Internal Revenue Code of 1954.
>
> These sections define and provide for exchange or capital treatment with respect to shareholders on distributions made in connection with partial liquidations of corporations.
>
> Section 346 defines partial liquidation in three different terms:
>
> (1) One of a series of distributions made–
>
> THE COURT: Let's not go into that, Mr. Nicholas. Just tell me, in a general way, without going into the sections applicable, what you expect to prove here today and by whom you expect to prove it.
>
> MR. NICHOLAS: I expect to prove
>
> (1) that the distribution, the disposition made in 1966, was a partial liquidation and a definite

substantial contraction in the activities of the Gooding Amusement Company;

(2) that this was part of the complete plan of [8] liquidation that has never been abondoned, and which in fact is being implemented right today, right now;

(3) I intend to prove that this Southern route was a distinct, autonomous operating business unit in itself, and the termination qualified as a partial liquidation under Section 346.

That's specifically, Your Honor, what I think our evidence is going to show in detail, the documentary evidence. (App. 21-22).

One of the purposes which the pretrial conference serves is to expedite disposition of cases by simplifying the issues and eliminating surprise. Rule 16 of the Federal Rules of Civil Procedure provides that the pretrial order "when entered controls the subsequent course of the action, unless modified at the trial to prevent manifest injustices."

Rule 15(b) of Fed.R.Civ.P. provides:

> When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings.

Where an issue, not included in the pretrial order, is actually tried by the parties, the aforementioned policies served by Rule 16 would not be served by the trial Court's refusal to consider the issue. Rule 16 should be read in the light of Rule 15(b). *Wallin* v. *Fuller*, 476 F.2d 1204, 1209-1210 (5th Cir. 1973); *Bucky* v. *Sebo*, 208 F.2d 304, 305 (2d Cir. 1953). *See Mayfield* v. *First Nat'l. Bank*, 137 F.2d 1013, 1016 (6th Cir. 1943).

As discussed below, the continuing existence of a plan of complete liquidation is relevant to a partial liquidation under

§ 346(a)(1). It is irrelevant to the existence of a partial liquidation pursuant to § 346(a)(2) or § 346(b).

F. E. Gooding, by codicil to his Will, directed his executors either to sell his stock in Thrills Unlimited and Gooding Amusement or to vote the stock for liquidation. The Will and Codicil were admitted as plaintiffs' Exhibit 23, without objection by the Government. E. C. Redman, who was an accountant for and a director of Gooding Amusement, testified that efforts were made to find a purchaser for the balance of the two corporations after the sale of the Southern Route; and Doris Relyea, an officer and director of the two corporations, testified that the corporations continued to have plans of complete liquidation. (App. pp. 40, 41, 42, 77, 78, 82, 83.) All of this evidence was admitted without objection.

Finally, Government counsel cross-examined Mr. Redman, attempting to elicit his agreement that § 346(a)(1) could not apply. (App. pp. 100, 101.)

The opening statements by both taxpayers' and Government counsel indicate that they each intended to make § 346(a)(1) an issue in the case.

No evidence pertaining to partial liquidation under § 346-(a)(1) was excluded by the trial Court; however, there were no findings of fact nor conclusions of law adopted concerning the applicability of § 346(a)(1) to the distributions. We decline to regard footnote 11 of the trial Court's opinion as adequate consideration of this important issue. The Court stated that the distribution would not qualify because there had been no series of distributions in redemption of all of the corporations' stock.

The series of distributions leading to a complete liquidation need not be completed by the time an action is brought or a judgment is rendered. *Maguire* v. *Commissioner*, 222 F.2d 472 (7th Cir. 1955).

The only real question in this case concerning the subsection is whether the taxpayers clearly proved that there was a settled and continuing informal plan to liquidate the cor-

porations. *Blaschka* v. *United States*, 393 F.2d 983, 988 (Ct.Cl. 1968); *Maguire* v. *Commissioner*, *supra*, at 479; *Horn & Hardart Baking Co.* v. *United States*, 34 F.Supp. 89, 90 (E.D.Pa. 1940). There is conflicting evidence on this issue. The District Court must also consider the alleged exercise of the option made during pendency of the appeal.

In no event would we want to hold that an otherwise valid claim for refund should be denied by a Court merely because the claimant may have also relied on inapplicable subsections of a section of the Internal Revenue Code.

The judgment of the District Court is affirmed as to the claims under Sections 346(a)(2) and 346(b) of the Internal Revenue Code, and is reversed as to the claim under Section 346(a)(1), and is remanded for a new trial on said Section 346(a)(1) claim.

It is ordered that two-thirds of the costs be assessed against appellants and one-third against the United States.

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

DONALD L. MAINS, and JOYCE G. MAINS, Plaintiffs	:	
vs.	:	Civil Action 71-126
UNITED STATES OF AMERICA, Defendant	:	
F. E. GOODING, Plaintiff	:	
vs.	:	Civil Action 71-127
UNITED STATES OF AMERICA, Defendant	:	

OPINION AND ORDER
(Filed June 21, 1976)

This matter is before the Court on remand from the Sixth Circuit Court of Appeals. Plaintiffs in their consolidated cases seek refund of federal income taxes paid for the year 1966.

Plaintiffs contend that certain distributions received by them in 1966 as stockholders of the Gooding Amusement Company, Inc. [hereinafter Gooding Amusement] and Thrills Unlimited, Inc. [hereinafter Thrills] qualified as amounts received as the result of a partial liquidation pursuant to Section 346 of the Internal Revenue Code, and were therefore taxable at the capital gains rate. The government denies that the transactions in question qualified as partial liquidations and contends that the distributions were taxable as ordinary dividend income.

Following the original trial of these actions, the Court held that the sales in question were not partial liquidation within the meaning of § 346(a)(2) or § 346(b) and that the distributions received by plaintiffs were properly treated as ordinary income. The opinion of this Court is reported at 372 F. Supp. 1093. This Court further concluded that the plaintiffs had not included the issue of a § 346(a)(1) partial liquidation in the final pretrial order and had not presented this issue at trial. In a footnote the Court concluded that "In any event, the sales in question would not qualify as a partial liquidation under § 346(a)(1) in that there has been no series of distributions in redemption of all of the stock of the two corporations."

The Court of Appeals affirmed this Court's judgment as to the claims under §§ 346(a)(2) and 346(b) of the Internal Revenue Code. It concluded, however, that the 346 (a)(1) issue should have been considered and that the footnote was not adequate consideration of this issue. Furthermore, the Court of Appeals held that there is conflicting evidence on the issue of whether or not there was a settled and continuing plan to liquidate the corporations, and directed this District Court to consider events affecting the corporations that occurred after this Court rendered its judgment. The Court of Appeals therefore reversed as to the 346(a) (1) claim and remanded the case to this Court. Pursuant to this Order, a further hearing was held to supplement the record of the original trial.

This Court will not repeat the extensive findings of fact and discussion found in its original opinion. This Opinion and Order will supplement the original findings and will rule thereon. Accordingly, the present findings of fact will commence with paragraph 21.

Findings of Fact

21. In January, 1967, F. E. Gooding learned that the Kaufman group was not going to exercise its option to purchase Gooding Amusement and Thrills. F. E. Gooding then attempted to find other purchasers for the corporation's assets so that

the total liquidation could be completed within the one year period mandated by 26 U.S.C. § 337. There is evidence that F. E. Gooding then talked with Rod Link, owner of World Pleasure Shows, but that Link did not have the money to finance the purchase. He may have talked also with a Mr. Wade and a Mr. Hroben. Additionally, Doris Relyea, the Secretary of Gooding Amusement and Thrills, made discrete approaches to L. Kountz of L. Kountz Shows and Jimmy Drew of James H. Drew Shows. At the same time F. E. Gooding told Doris Relyea that he would be willing to sell her three units of approximately 10 rides apiece, stating that he would sell the balance piecemeal. She declined the offer.

22. After these efforts to liquidate the corporations had failed, F. E. Gooding wrote a letter on March 24, 1967 to the stockholders which was read at the annual meetings of the two corporations held on the same date:

Dear Friend and Stockholder:

As you know, on April 5, 1966, we voted to liquidate all of the assets of the Corporation. At the time this decision was made, there were several problems facing the Corporation. My health was very bad and I had no prospect of ever returning to work.

Attempts to organize the employees of the Corporation had been made by a Labor Union and it appeared, at that time, that these attempts might be successful.

Primarily because of my illness and absence from the office, competitors were making inroads with our customers and it appeared that we might well lose some of our good accounts.

My absence also created a problem in the supervision of our far-flung operation, particularly when the units were on the road. The Southern Route raised particular problems because of its operation in seven different states.

We had a problem keeping good employees, in my absence, because they did not feel the same sense of loyalty as when I had been able to take an active part in the business.

Frankly, last April I expected to never see another season

and felt that my death would greatly reduce the value of your interest in the Corporation as well as the interest of my heirs.

It was for these reasons, as I told you at our meeting last April, that it seemed that we had no choice but to completely liquidate the Corporation.

After our decision to liquidate the Corporation, we were able to sell the Southern Route. I had every reason to believe that the persons who bought the Southern Route would offer to buy the remainder of the corporate assets.

We were fortunate in being able to sell the Southern Route as a package without splitting it up, and, therefore, got a good price.

I have had many conferences with the persons who bought the Southern Route in an attempt to sell them either all of the corporate assets or, at least, some other units. It was not until January of this year that they finally told me that they were not interested in purchasing other assets or units.

I want you to know that even before they made this decision, I had made several other attempts to sell some or all of the remaining equipment. I was hampered in these efforts by the fact that any advertising of our plan of liquidation would have been used by competitors in an effort to steal our contracts and employees.

This was not too big of a problem as I was able, by personal contacts, to let the right people know we were liquidating and solicit offers to purchase.

We received no legitimate offers to purchase any part of the Corporation. As we were in the process of liquidating, I could only look to cash buyers so we would have had funds to distribute to the stockholders and to pay our taxes, both corporate and personal.

Many things have changed since last April. My health, thank God, has greatly improved. For the past several weeks I have been able to get to the office every day and can now, once again, take an active part in the management of the

Corporation.

On reviewing our Financial Statement since the sale of the Southern Route, I am happy to note an increase in profits. It may have been that we were spreading our operation too thin and in too far-flung a fashion. Now that we have contracted our operation, I think it is being run on a sounder, more economical basis.

The Labor Union has not as yet been successful in organizing our employees.

Now that I am back to work, we have been able to better resist efforts of competitors to take some of our contracts.

Supervisory problems have been reduced due to the sale of the Southern Route as this makes our present operation more consolidated.

I am sure, with my return to active management of the Corporation, that our employment problems will be reduced. We must reconsider our plan of corporate liquidation as it is impossible to sell the remainder of the corporate assets.

Judging from last year, we can continue to make a profit from the business. Therefore, I seek your suggestions with respect to our corporate liquidation.

Sincerely,
F. E. Gooding, President

23. Prior to the March 24, 1967 shareholders' meetings, the corporations' accountant, Edmond C. Redman, prepared a memorandum stating that the corporations were unable to qualify for a total liquidation under § 337 because management had been unable to negotiate a sale of the remaining operating equipment and real estate. The memorandum contained alternatives including "Plan One" pursuant to which the corporation would continue in operation and make no further liquidating dividends. The discussion of Plan One in the memorandum sets out the complete text of 26 U.S.C. § 346 (a)(1), (2). The memorandum also indicates that there is a distinction between § 346(a)(1) and § 346(a)(2).

24. The minutes of the 1967 Annual Consolidated Shareholders' and Directors' Meeting of Gooding Amusement and Thrills indicates that following the reading of F. E. Gooding's letter, a discussion was had of the points raised in the letter. Then a motion carried to amend the plan of liquidation previously adopted and to consider distributions made after the sale of the Southern Route "as a partial liquidating distribution." Then a motion was passed authorizing the officers and directors to take the steps necessary to amend the corporation's income tax returns and to notify the Internal Revenue Service of the amendment to the plans of corporate liquidation.

25. Mr. Redman then prepared and Doris Relyea as Secretary caused to be filed Form 966 for both Gooding Amusement and Thrills amending the April 5, 1966 plan of liquidation under 26 U.S.C. § 337 "to a plan of partial liquidation under I.R.C. Sections 346(a)(2) and 331(a)(2). . . . ." The corporations also took steps to redeem shares of stock pursuant to the partial liquidation.

26. As his letter indicates, F. E. Gooding resumed active management of the corporations for a time. Doris Relyea testified that "Mr. Gooding's health did improve then." An April 15, 1968 letter from Mrs. Relyea as Secretary of Thrills indicates that F. E. Gooding had "resumed his full administrative duties in June, 1967." It also states that following the partial liquidation "Mr. Gooding's health improved again to the point where he could spend time in the active management of the business."

27. The Court finds that there is no credible evidence that the corporations actively sought to find a purchaser through liquidation or sale of stocks from March, 1967 through early 1971. The only evidence of a contract during that period was that with Jerry L. Kaltenbach the ultimate purchaser. Mr. Kaltenbach became an assistant manager of the Ohio State Fair in 1967. In December of that year, he became manager of the Ohio State Fair. Kaltenbach testified that he believed F. E. Gooding talked with him about Gooding Amusement sometime in 1968; but that he then had no interest

in getting into the amusement business. It was Kaltenbach's recollection that he did not seriously explore the possibility and feasibility of acquiring Gooding Amusement until late 1970 and early 1971.

28. Plaintiffs presented no expert medical testimony concerning the state of F. E. Gooding's health at the various relevant times, but it is clear that by late 1971, and perhaps before, he was again seriously ill and desired to dispose of his interest in the corporations.

29. On January 29, 1971, the Consolidated Shareholders' and Directors' Meetings of Gooding Amusement and Thrills were held in the bedroom of F. E. Gooding's home. Doris Relyea testified that F. E. Gooding told the shareholders assembled "that he was unable to participate in any activity in the company because of his health, [and] he was unable to sell it to anyone with a substantial down payment, and he thought perhaps [entering the management contract and option agreement with Kaltenbach] would be the best way for the shareholders." The management contracts were executed December 29, 1971 and became effective February 1, 1972. Kaltenbach became solely responsible for the management of the corporations. The joint option agreements, executed December 31, 1971, provided that they could not be exercised earlier than the date of F. E. Gooding's death. The options extended to six months following F. E. Gooding's death; and in any event the options extended to June 30, 1974. The options also provided that the shareholders could elect to sell stock rather than to liquidate corporate assets.

30. F. E. Gooding died August 17, 1972. Kaltenbach wrote a letter to the corporations in June, 1974, stating that he would exercise the option. Ultimately Kaltenbach did not purchase in accordance with the method of payment outlined in the option agreement. After extended negotiations, he did enter an agreement in May, 1975 to purchase the assets of the corporations. The shareholders did not exercise their right to sell stock instead of assets.

31. From August 31, 1965, through August 31, 1970, the cost of operating assets of Gooding Amusement reduced from $2,373,000.00 to $2,178,000.00. From August 31, 1965 through August 31, 1972, the net worth of Gooding Amusement was reduced from $1,544,777.28 to $617,669.52. From June 30, 1965 through June 30, 1971, the net worth of Thrills increased from $180,118.04 to $242,947.78. However, the average net operating income of Thrills declined from $43,952.43 for the six fiscal years preceding the sale of the Mad Mouse to $13,701.20 for the following five fiscal years.

Conclusions of Law

Section 346(a)(1) of Title 26, United States Code, provides:

> (a) *In general* — For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if —
>
> (1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan. . . .

The parties are in agreement that whether there is a plan of distribution is to be determined at the corporate level. It is not necessary that there be a formal plan of liquidation. But if the 1966 sales are to qualify as a partial liquidation under § 346(a)(1), there must be "a settled and continuing informal plan to liquidate the corporations." *Mains v. United States*, 508 F. 2d 1251, 1260 (6th Cir. 1975). Plaintiffs have the burden of proving their entitlement to a refund. *Helvering v. Taylor*, 293 U.S. 507, 514-515 (1935). *See generally*, Mertens, *Law of Federal Income Taxation* § 58A.01.

The Court finds that plaintiffs have failed to meet their burden of pursuasion. The Court is convinced by a preponderance of the evidence that the April 5, 1966 plan of complete liquidation was abandoned, and that the corporations elected to forego further attempts at liquidation. There is no written indicia of an informal plan of liquidation; and between March, 1967 and early 1971 there were no significant corporate activities

demonstrating the existence of a settled, continuing, informal plan of total liquidation. What written evidence there is indicates the Corporation opted to seek tax treatment for the sales under § 346(a)(2); and that an informed decision was made not to adopt a plan of total liquidation which would entitle the Corporation to claim the sales as partial liquidations under § 346(a)(1). Further whatever "plan" existed in late 1971 was equally consistent with continuation of the corporation as with liquidation because the shareholders retained the option of selling the stock rather than liquidating the corporation's assets. Even if the Court were to conclude — as it does not — that F. E. Gooding would throughout the period have disposed of his interests and those of the other shareholders could he have found a purchaser, plaintiffs have failed to demonstrate that he had a settled and continuing plan to do so through complete liquidation.

Accordingly, the Court HOLDS that plaintiffs' claim for relief under 26 U.S.C. § 346(a)(1) is without merit, and therefore it is DENIED.

WHEREUPON, the Court determines that judgment should be, and hereby is, entered for defendant, United States of America.

No. 76-2443
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

DONALD L. MAINS and JOYCE G. MAINS,
Plaintiffs-Appellants,
v.
UNITED STATES OF AMERICA,
Defendant-Appellee.

ORDER

F. E. Gooding,
Plaintiff-Appellant,
v.
UNITED STATES OF AMERICA,
Defendant-Appellee.

Decided and Filed April 14, 1978

Before: WEICK and ENGEL, Circuit Judges and CECIL, Senior Circuit Judge

In a previous appeal, *Mains, et al. v. United States of America*, 508 F.2d 1251 (6th Cir. 1975), this court, while affirming the district court's decision denying plaintiff taxpayers relief under §§ 346(a)(2) and 346(b), reversed as to the court's denial of relief under § 346(a)(1) of the Internal Revenue Code and remanded the case for trial on that claim. Upon remand, the district court made additional findings of fact and conclusions of law in which it held that upon the evidence before it, the plaintiffs had failed in meeting their burden to show that the 1966 sale of corporate assets was part of a settled and con-

tinuing informal plan to liquidate the corporation, entitling the sale to be construed as a partial liquidation under § 346(a)(1). Upon consideration, it appearing that the findings of fact by the district judge are not clearly erroneous and that he properly applied the legal standards set forth by this court in the earlier appeal,

IT IS ORDERED that the judgment of the district court is affirmed.

ENTERED BY ORDER OF THE COURT

No. 76-2443
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

DONALD L. MAINS and JOYCE G. MAINS,

Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

ORDER

F. E. GOODING,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Decided and Filed May 31, 1978

Before: WEICK and ENGEL, Circuit Judges and CECIL, Senior Circuit Judge

No judge in regular active service of the court having requested a vote on the suggestion for a rehearing en banc, the petition for rehearing filed herein by the plaintiffs-appellants has been referred to the panel which heard the original appeal. Upon consideration of said petition, the court concludes that it is without merit. Accordingly,

IT IS ORDERED that the petition for rehearing is hereby denied.

ENTERED BY ORDER OF THE COURT

Supreme Court, U. S.
FILED
OCT 28 1978
MICHAEL RODAK, JR., CLERK

No. 78-341

In the Supreme Court of the United States

OCTOBER TERM, 1978

DONALD L. MAINS, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-341

DONALD L. MAINS, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question in this federal income tax case is whether certain corporate distributions made to the shareholders after the assets of the corporations were sold should be taxed as ordinary income or capital gains.

The pertinent facts are as follows: Petitioners were shareholders of two corporations—Gooding Amusement Company, Inc. and Thrills Unlimited, Inc. On April 5, 1966, the two corporations entered into plans of complete liquidation pursuant to Section 337 of the

Internal Revenue Code of 1954.[1] On April 6, 1966, pursuant to the plans, Gooding sold an aggregation of equipment contract rights and goodwill known as "Goodings Million Dollar Midway" or the "Southern Route" for $350,000; Thrills sold a ride known as the "Mad Mouse" to the same purchaser for $25,000. The sales proceeds were distributed pro rata to the shareholders of the two corporations. Both corporations had earnings and profits exceeding the amounts of the distributions (Pet. App. 18-19).

The Southern Route was the largest of ten carnival operating units run by Gooding. The Southern Route played larger fairs than the other units but operated for fewer days and operated primarily in the South rather than the Midwest, as the other units did. The Southern Route accounted for 38.65% of Gooding's revenues and 47.91% of its expenses (Pet. App. 16-17). Thus, the smaller Midwest units were more profitable on a percentage of receipts basis, but the Southern Route earned more than any other route (Pet. App. 17, 26, 34).

Subsequent to April, 1966, Gooding and Thrills abandoned their plans of complete liquidation; on

[1] Under Section 337, if a corporation completely liquidates within twelve months of the adoption of the plan of complete liquidation, no gain or loss is recognized by the corporation on the sale of its assets. If the proceeds of sale are distributed to the shareholders in either a partial liquidation qualifying under Section 346 or a complete liquidation, Section 331 provides that the shareholders recognize capital gain or loss measured by the difference between the value of their distribution and the basis in their stock.

March 24, 1967, they formally amended their plans of liquidation to plans of partial liquidation. On their 1966 tax returns, petitioners took the position that the amounts distributed were payments in partial liquidation of the corporations and, therefore, were taxable at capital gains rates. On audit, the Commissioner of Internal Revenue determined that the transactions were not partial distributions and that the distributions were taxable as ordinary dividend income (Pet. App. 15).

In this refund suit brought by petitioners in the United States District Court for the Southern District of Ohio, the district court held that the sales of assets by both Gooding and Thrills were not partial liquidations under Section 346(a)(2) or (b). It therefore concluded that the distributions received by petitioners were properly taxed as ordinary income (Pet. App. 32).

The court of appeals affirmed as to the district court's holding with respect to Section 346(a)(2) and (b). However, it reversed and remanded the case for a new trial to consider petitioners' claim that the transactions were partial liquidations under Section 346(a)(1), *i.e.*, one of a series of distributions in redemption of all of the stock of the corporations pursuant to a plan (Pet. App. 33-48).

1. The court of appeals correctly held that the distributions by Gooding and Thrills to petitioners were not made pursuant to partial liquidation under Section 346(a)(2) and (b) of the Code. As the court of appeals noted (Pet. App. 37), Section 346

(a)(2) of the Code includes within the definition of partial liquidation those distributions that are not "essentially equivalent to a dividend." The legislative history establishes that qualification under this subsection depends primarily on the existence of a bona fide corporate contraction. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A112 (1954). Here, however, there was no such contraction by either Gooding or Thrills. Although both corporations sold some of their assets, the district court found that in the year following the sale they purchased additional assets having values in excess of the assets sold. The court of appeals therefore concluded that "[c]onsidering the increased purchase of equipment and the relatively small fraction of the assets disposed of, the District Court's finding that there was not a contraction is supported by substantial evidence, and is not clearly erroneous" (Pet. App. 40).

Petitioners argue (Pet. 7-10) that the court of appeals erred in refusing to uphold their claim that the distributions were "one of a series of distributions in redemption of all of the stock of the corporation[s] pursuant to a plan" so as to qualify as a partial liquidation under Section 346(a)(1). In petitioners' view, the fact that the corporations entered into plans of complete liquidation in April 1966 is dispositive of the matter because the distributions at issue were made in 1966. Petitioners urge that the annual method of accounting renders irrelevant the fact that the plans were subsequently abandoned during the following year.

But the decisions of this Court establish that the annual method of accounting does not foreclose consideration of events occurring outside the taxable year in determining the tax consequences of distributions or payments. Cf. *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952); *United States* v. *Skelly Oil*, 394 U.S. 678 (1969). Indeed, if petitioners were correct that the 1967 abandonment of the plans of liquidation was irrelevant, it would be a relatively simple matter for shareholders to achieve capital gains by having their corporation adopt a plan of complete liquidation, sell some assets and distribute the proceeds, and then abandon the plan during the following year. *Maguire* v. *Commissioner*, 222 F.2d 472 (7th Cir. 1955), upon which petitioners rely (Pet. 8-9), is not to the contrary. There, the court took into account events occurring after the close of the taxable year and found "a persistent and uninterrupted intention to pursue the plan to final liquidation" (222 F.2d at 479). Hence, *Maguire* is entirely consistent with the decision below.

2. Petitioners further contend (Pet. 10-11) that the court of appeals erred in defining a corporate contraction only in terms of percentage reduction in net worth. But the court did not so hold. To the contrary, the court suggested that there was no corporate contraction at all because both Gooding and Thrills had replaced the equipment that they sold. In the three years immediately following the sale of the Mad Mouse for $25,000, Thrills purchased $149,000 of new equipment, and in the year of sale, Gooding pur-

chased new equipment at a cost in excess of the book value of all the equipment that it sold (Pet. App. 39). Further, the court noted (Pet. App. 40) that "[t]he relative percentage of the assets sold to the entire net worth of the corporations is only one factor to be considered" and that a determination as to the existence of a corporate contraction must be made on the facts of each case. Thus, the court of appeals did not measure corporate contractions solely in terms of percentage reduction in net worth.

3. Finally, petitioners argue (Pet. 11-13) that the court of appeals applied an improper legal standard in determining that Gooding's Southern Route was not a separate trade or business. If the Southern Route was a separate trade or business, then its sale and the payment of the proceeds to the shareholders would have qualified as a partial liquidation ("termination of a business") under Section 346(b).

Both courts below correctly determined that the Southern Route was not a separate trade or business because (1) it was not a viable, separate entity, which included every operation necessary to deliver the service and earn income; and (2) it had no separate supervision and control (Pet. App. 29-30, 42-43). Petitioners err in asserting (Pet. 12) that the decision below held that "almost any degree of participation in or control of non day-to-day * * * business operations by general management is sufficient to defeat any portion of a corporation's business activity from being considered a separate 'trade or business.'" Here, the court of appeals affirmed the district court's finding that Gooding did not conduct two separate businesses, because most management, administration and storage activities were performed as one integrated function, by the same personnel at the same location, except for such activities as could practicably be performed only separately by the Southern Route manager while on tour.

This aspect of the decision below conforms to the definition of "trade or business" provided in Treasury Regulations, Section 1.355-1(c) (26 C.F.R.), as incorporated by Treasury Regulations, Section 1.346-1(c)(2) (see Pet. App. 41). Accord: *Blaschka* v. *United States*, 393 F.2d 983 (Ct. Cl. 1968). While petitioners correctly point out (Pet. 12) that there has been some judicial criticism of Section 1.355-1(c) of the Regulations,[2] those observations were directed solely at Section 355 and not Section 346(b). The latter provision, at issue here, envisions the existence of two separate businesses. Moreover, the legislative history of Section 346 is equally clear as to the necessity of two separate businesses. See S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

OCTOBER 1978

[2] See *King* v. *Commissioner*, 458 F.2d 245 (6th Cir. 1972); *Rafferty* v. *Commissioner*, 452 F.2d 767 (1st Cir. 1971).

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vs.

UNITED STATES OF AMERICA, *Respondent.*

F. E. GOODING, *Petitioner*

vs.

UNITED STATES OF AMERICA, *Respondent.*

REPLY BRIEF

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REPLY BRIEF

INTRODUCTION

It appears that the Memorandum For the United States in Opposition to the Petition for a Writ in these cases filed by the Solicitor General was beyond the time prescribed by Rule 24 of this Court. On the assumption that the Court may consider said memorandum in its deliberation of the fate of the Petition the following short reply respecting new matter is presented.

REPLY

In the course of arguing and briefing these cases at the trial and appellate level, Petitioners have always recognized the propriety and sometimes the necessity of examining conduct occurring in tax years subsequent to the years before the Court in determining the authenticity and genuineness of a particular transaction before the Court. *Estate of William G. Maguire* 50 TC 130 (1968). This was uniquely so in analysing a transaction under the partial liquidation provisions of Sec. 346 (a)(1) of the Internal Revenue Code of 1954.

The Solicitor General in his memorandum has now crystalized the basic conflict involved and interjected an entirely new concept (principle) into the already unsettled waters of what constitutes a "tax year" and what, if any, "integrity" it is to be accorded.

Arrowsmith v. Commissioner 344 U.S. 6 (1952) and *United States v. Skelly Oil* 394 U.S. 678 (1969) both stand for the shaky rule that the characterization of a taxable transaction in a given year can be governed by the tax treatment of events occurring in previous years. (Note the vigorous dissents in these cases.) Our Government now cites this as authority for the proposition that events occurring in years subsequent to those before the Court can determine for tax purposes the characterization of transactions occurring in prior years.

Petitioners suggest that the thrust of the Government's argument represents yet another erosion and disintegration of both the legislative and this Court's purpose in according a reasonable degree of honor and integrity to the concept of annual accounting.

The impact of leaving this problem unresolved is enormous both from the standpoint of maintaining a fair and equitable administration of the tax code as well as giving at least a modicum of assurance to taxpayers in ordering their personal and economic lives.

The dilemma may be best summed up by the comment of one of our leading tax authorities as follows: "The extent to which the Arrowsmith decision has driven a wedge into the doctrine of the single year as a unit of taxation remains unanswered." Mertens, *Law of Federal Income Taxation*, Sec. 12.06, fn. 78.1.

It is therefore respectfully submitted that the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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